

increases were possible even when a low-end adjustment filing was not: "LECs also retain the opportunity to demonstrate on a case-by-case basis that an adjustment in their allowed rate levels will be necessary to prevent a confiscatory outcome."<sup>30</sup>

By these statements, all the Commission did was acknowledge that due to Constitutional limits on its authority, it might also have to allow rate increases in "extraordinary" situations where exogenous or low-end adjustments were not ordinarily permitted. That is almost the opposite of Ad Hoc's and ICA's suggestion that the Commission established a "confiscation" standard for exogenous adjustments.

The Southwestern Bell case that Ad Hoc and ICA cite (ETI Report, p. 7) was decided on particular facts and does not support the confiscatory standard they propose. In that case, Southwestern Bell sought an increase in its July 1, 1990 rates through a mid-course correction under rate of return rules. Due to cost increases, including the cost of a discretionary early retirement program, Southwestern Bell's rates were earning less than their targeted rate of return. The Bureau rejected the rates on the grounds that the increases were not permissible during the changeover to price cap regulation. On review, four members of the Commission affirmed. The Commission held that because the increased rates would be the starting point for Southwestern Bell's price cap, they should be subjected to

---

<sup>30</sup> LEC Price Cap Order, 5 FCC Rcd at 6807 (para. 165) (emphasis added).

"heightened scrutiny."<sup>31</sup> It then applied this "heightened level of scrutiny" to Southwestern Bell's cost support and held that most of the increase should be denied.<sup>32</sup>

Ad Hoc and ICA have quoted out of context the dicta in that decision about exogenous costs. Southwestern Bell did not seek an exogenous adjustment; price cap regulation was not in effect when the rates were filed.<sup>33</sup> Rather, what Southwestern Bell contended was that "the Bureau's failure to allow Southwestern Bell an opportunity to earn the authorized rate of return going into price cap regulation is confiscatory."<sup>34</sup> The Commission denied this because "SWB has made no showing that supports a finding that it is unable to attract capital."<sup>35</sup> The Southwestern Bell order did not deal with a request for an exogenous cost adjustment and did not change the standard for recovery of exogenous costs. As shown above, the two prongs of that standard are (1) the exogenous costs must be triggered by events outside the control of the carrier, and (2) the carrier

---

<sup>31</sup> See Southwestern Bell, 7 FCC Rcd 2906, 2909 (para. 20) (1992), appealed sub nom. Southwestern Bell Tel. Co. v. Federal Communications Commission, No. 92-1220, D.C. Cir. In a separate statement, Commissioner Barrett criticized this imposition of "a new more stringent standard" not explicitly found in the LEC Price Cap Order. 7 FCC Rcd at 2920.

<sup>32</sup> Id., para. 21.

<sup>33</sup> Id., para. 6.

<sup>34</sup> Id., para. 36.

<sup>35</sup> Id., para. 40.

must show that the exogenous costs will not be recovered through changes to the GNP-PI.<sup>36</sup>

Similarly, MCI asserts that recovery of OPEB costs is unnecessary because "the low-end adjustment formula would serve as an adequate transitioning mechanism if price cap LECs do not receive exogenous treatment." MCI, p. 23. MCI acknowledges that "LEC earnings might be negatively affected to some extent," but asserts "[t]he low end adjustment formula will protect the LECs from inordinately sharp drops in earnings." Id., pp. 23-24.

The low end adjustment formula is not supposed to protect carriers against the effects of exogenous events. It was expressly designed to "ensure that the [price cap] plan automatically corrects itself should [the Commission's] selection of a productivity factor for the industry turn out to be too high for a given company."<sup>37</sup> The low end adjustment feature was proposed to allay concerns about applying the same industry-wide productivity benchmark to carriers with different cost and capital structures.<sup>38</sup> The Commission explained that "[s]ome variability in achieved rates of return is an expected feature of incentive regulation, but such regulation is not meant to reward

---

<sup>36</sup> LEC Price Cap Reconsideration Order, 6 FCC Rcd at 2665 (para. 63).

<sup>37</sup> LEC Price Cap Order, 5 FCC Rcd at 6788 (para. 10).

<sup>38</sup> Second Further Notice, 4 FCC Rcd at 3212-3216 (paras. 701-710).

or penalize carriers on the basis of random differences or errors in setting the productivity factor."<sup>39</sup>

The Commission determined that the carriers' July 1990 rates represented "the most reasonable basis from which to launch a system of price cap regulation".<sup>40</sup> Those rates were adjusted through an exogenous cost decrease specifically to reflect the 11.25% rate of return the Commission prescribed.<sup>41</sup> The rate of return prescribed by the Commission for the LECs was supposed to be "the minimum level necessary for the utility to maintain its credit and attract the capital needed to provide service."<sup>42</sup>

Pacific Bell estimates that if its OPEB tariff is not allowed to take effect, its earnings would be reduced by about 64 basis points (i.e., .64%). Even if capital could still be attracted and service maintained at this level, it would penalize carriers without furthering any legitimate regulatory policy. The Commission itself has observed that OPEB expenses are reasonable and prudent.<sup>43</sup> Rates that do not recover such

---

<sup>39</sup> Id., at 3214 (para. 706).

<sup>40</sup> LEC Price Cap Order, 5 FCC Rcd at 6814 (para. 230).

<sup>41</sup> The 11.25% rate of return was adopted at the same time as the LEC Price Cap Order. See Represcribing the Authorized Rate of Return for Interstate Services of Local Exchange Carriers, 5 FCC Rcd 7505 (1990) ("Represcription Order").

<sup>42</sup> Illinois Bell v. FCC, 911 F.2d 776, 779 (D.C. Cir. 1990) (emphasis added). See also United States v. FCC, 707 F.2d 610 (D.C. Cir. 1983), and AT&T, 57 F.C.C. 2d 960, 960-61 (1976).

<sup>43</sup> See above, n.24.

expenses have been held to be unreasonably low. As the D.C. Circuit observed in Mississippi River Fuel, if expenses are "properly incurred, they must be allowed as part of the composition of the rates. Otherwise, the so-called allowance of a return upon the investment, being an amount over and above expenses, would be a farce."<sup>44</sup>

The Commission has stated that it will accept exogenous cost adjustments on a case-by-case basis. It has set forth two criteria for exogenous cost recovery: (1) the exogenous costs must be triggered by events outside the control of the carrier, and (2) the carrier must show that the exogenous costs will not be recovered through changes to the GNP-PI.<sup>45</sup> The Pacific Companies have met both criteria. They are entitled to recover all reasonable and prudent accrued OPEB expenses in their rates.

D. Almost None of the Exogenous Cost of SFAS 106 Will Be Recovered In Changes to the GNP-PI.

The NERA study demonstrated that because prices in unregulated markets already reflect the economic costs of postretirement benefits, adoption of SFAS 106 will not cause prices to change. Hence, the effect of SFAS 106 on output prices is confined to the cost-plus sector, and the estimated effect on the rate of growth of GNP-PI is less than 0.12% per year. The parties opposing the Pacific Companies' Direct Case fail to

---

<sup>44</sup> 163 F.2d at 437.

<sup>45</sup> LEC Price Cap Reconsideration Order, 6 FCC Rcd at 2665 (para. 63).

refute this study or show that an exogenous adjustment for OPEB costs would lead to double recovery.

AT&T contends that a "double count occurs because (i) the GNP-PI component of the PCI will increase as all firms with OPEB liabilities reflect those costs through higher prices, and (ii) the SFAS 106 accrual calculation includes the present value of future inflation." AT&T, p. 7. Elaborating on its first point, AT&T says the NERA study "is flawed because it rests on the empirically unsupported assumption that nonregulated profit-maximizing firms already include the present value of OPEB costs in their pricing decisions and therefore the imposition of SFAS 106 accounting will not cause any future change in their prices." AT&T, App. C, p. 2 of 6. AT&T says that "a much more reasonable assumption is that nonregulated firms are constantly revising their perceptions of costs (and therefore, prices) as more accurate information becomes available over time. Firms would tend to put less emphasis on accrued costs and more on cash costs in decision making." Id., p. 4 of 6.

NERA's reply is attached to this Rebuttal as Exhibit 1. Essentially, while acknowledging that firms make decisions based upon economic costs (id., p. 3 of 6), AT&T's argument fails to recognize that accrued costs are relevant economic costs. As NERA shows, competitive firms do not fail to make this distinction, because competition forces prices to reflect economic costs. The economic cost of OPEBs is incurred at the time of an employee's service, not when benefits are paid.

AT&T's second point (that the SFAS 106 accrual calculation includes the present value of future inflation) is also fallacious. According to AT&T:

Inflation enters the SFAS 106 accrual calculation through the health care trend term which captures, in addition to other effects, the effect of increases in the prices of medical goods and services. If the general rate of inflation increases, the rate of health care inflation (which includes general inflation plus influences that are specific to the health care sector) would also increase.

AT&T, p. 13, n. \*\*. AT&T suggests that LECs be required to subtract the expected rate of change of GNP-PI from the health care inflation component in the SFAS 106 accrual. Id., p. 13. Its articulation is not very clear, but what AT&T appears to mean is that an exogenous adjustment would compensate carriers twice for medical inflation -- once in the SFAS accrual calculation, and once in future changes to the GNP-PI. MCI makes essentially the same point and suggests essentially the same "correction." MCI, pp. 29-31.

AT&T and MCI are both wrong. In accordance with SFAS 106, the annual accrued expense of OPEBs is the sum of several components--service cost, interest cost and amortization of the unrecognized transition obligation, unrecognized prior service, and actuarial gains and losses. The expected return on plan assets and amortized gains are subtracted from the above components of costs to give the annual net accrued expense of benefits reflected as an expense in the income statement. In other words, carriers first estimate the ultimate dollar cost of

SFAS 106 using the health care trend rate and other factors. SFAS 106 then requires these dollars to be reduced to present value using a discount rate. Inflation is thus removed. This present value amount is the carrier's actual current cost of OPEBs. This was explained in NERA's study (pp. 23-24).

The Pacific Companies' estimate of medical inflation in its SFAS 106 accrual was conservative and should result in no overrecovery.<sup>46</sup> AT&T would reduce OPEB expenses to constant dollars, then deflate those dollars using a nominal discount rate. In other words, it would discount OPEB expenses for inflation twice, when they should be discounted only once. This is also demonstrated by NERA in Exhibit 1 (pp. 18-19). Accordingly the "correction" that AT&T suggests would cause revenues to fall short of OPEB costs.

Ad Hoc and ICA attack NERA's estimate of the effect of SFAS 106 on GNP-PI. But they do not succeed in rebutting it. As Exhibit 1 shows, the ETI Study makes several criticisms which, if true, would actually decrease NERA's estimate of the effect of SFAS 106 on the GNP-PI.<sup>47</sup> MCI's attack on the NERA study (MCI, pp. 21-22) lacks any substance at all. The Pacific Companies

---

<sup>46</sup> Pacific Bell currently experiences annual inflation in medical costs of about 14%. Its tariff filing used a health care trend rate that began with this actual figure and diminished to 6.25-6.50% by the year 2001.

<sup>47</sup> Exhibit 1, pp. 6-12.

have proven that only a small portion of the effect of SFAS 106 will be recovered through increases to the GNP-PI. They should be permitted to recover the remainder through an exogenous cost adjustment to their price cap indices.

E. The Prescribed Rate of Return Does Not Reflect Any Increase in SFAS 106 Costs.

MCI alleges that if carriers are allowed to recover SFAS costs, a different kind of double recovery will occur. MCI says:

LECs, as well as their shareholders, have already been at least partially compensated for the costs associated with the accrual of SFAS-106 costs. The attached affidavit by Professor Allan Drazen ... illustrates that the cost of equity as calculated during the recent rate of return prescription has already captured the costs of SFAS-106, and any additional amounts awarded to the LECs for this accounting change would result in some double recovery of these costs.... not only were the implicit costs associated with OPEB already recognized by the market and captured within share prices far in advance of the rate of return proceeding, but also the impacts from SFAS-106 accounting treatment were also reflected in the cost of equity used by the Commission to determine the represcribed rate of return.

MCI, pp. 11-14.

MCI does not prove its point. MCI mischaracterizes NERA's statement about the effect of SFAS 106 on stock prices, misunderstands the Discounted Cash Flow (DCF) model, and misleads about the findings of the Mittelstaedt and Warshawsky study that it cites in support of its position. Finally, even if MCI's

argument were otherwise correct, MCI ignores components of the DCF model that would offset any effects on stock prices from reduced investor expectations of earnings.

MCI implies that NERA's conclusion that SFAS 106 has had no effect on stock prices was based on the fact that there is "virtually no literature" on the subject. "Such a contradiction," says MCI, "provides further evidence that the attempts by the LECs to have exogenous treatment afforded SFAS-106 costs are not grounded in any concrete analysis." MCI, p. 16. This is misleading. In fact, NERA performed an exhaustive search of literature, and the literature that exists supports NERA. NERA stated that "a search of the empirical literature reveals two studies of the effects of these accounting changes which both show no relationship between accounting changes and stock prices."<sup>48</sup> MCI appears not to have examined

---

<sup>48</sup> NERA said: "NERA undertook a DIALOG Database system search of the relevant literature, including the Economic Literature Index (1969 to present), the Academic Index (1976 to present), the Conference Papers Index (1973 to present), Management Contents (1974 to present) and Dissertation Abstracts (1961 to present). These databases were searched using as Keywords: "FASB," "Financial Accounting Standards Board," "Statement 87," "87," "pensions," and "economic." Fifteen publications were identified and two were relevant: (i) Sheree S. Ma, "An Empirical Examination of the Stock Market's Reaction to the Pension Accounting Deliberations of the Financial Accounting Standards Board," Doctoral Dissertation, University of Alabama, 1989, and (ii) Samuel S. Tung, "Stock Market Reactions to Mandatory Changes in Accounting for Pensions," Doctoral Dissertation, University of Wisconsin, 1987. Both works showed that no changes in stock prices could be attributed to the 1987 pension accounting changes. Since the effect of these accounting changes varied widely across companies, the fact that stock prices remained unchanged implies that output prices cannot have changed significantly." NERA Study, p. 28.

and did not attempt to rebut these two studies.

MCI relies heavily on the Mittelstaedt and Warshawsky Study to support its conclusion that SFAS 106 has depressed stock prices.<sup>49</sup> However, the Mittelstaedt and Warshawsky Study is inconclusive. Mittelstaedt and Warshawsky assume that stock prices must be affected by SFAS 106 deliberations. But they admittedly do not find much of an effect; in fact, the study is largely devoted to rationalizing why the expected effect was not found. They found that "the market is aware of corporate liabilities for retiree health benefits" (which is indisputable, and consistent with NERA's study) but concluded, with some frustration, that either "a high degree of imprecision surrounding estimates of the liabilities" or "a large degree of uncertainty regarding future corporate or government actions" had prevented the market from reflecting SFAS 106 effects as they had expected. Mittelstaedt and Warshawsky Study, p. 1. The more obvious explanation -- that stock dividends and prices already reflected the real cost of postretirement obligations, with or

---

<sup>49</sup> Mark J. Warshawsky, "Postretirement Health Benefit Plans: Costs and Liabilities for Private Employers," Finance and Economics Discussion Series paper 76, Division of Monetary Affairs, Federal Reserve Board, Washington, D.C., June 1989; H. Fred Mittelstaedt and Mark Warshawsky, "The Impact of Liabilities for Retiree Health Benefits on Share Prices," Finance and Economics Discussion Series paper 156, Division of Monetary Affairs, Federal Reserve Board, Washington, D.C., April 1991 (the "Mittelstaedt and Warshawsky Study").

without SFAS 106 disclosure -- they did not explore. They did admit that "Standard & Poor's Corporation (1989) and some stock analysts ... state that bond ratings and stock prices already reflect rough estimates of retiree health liabilities" (Mittelstaedt and Warshawsky Study, p. 6), also consistent with NERA's study.<sup>50</sup> They apparently are unaware of the two studies that NERA cites. Their regression results depict exceptionally weak correlation indicators of from .41 to .56. Id., Tables V, VI. In addition, they admit that "[t]he standard errors for the retiree health plan coefficients are high, thereby making point estimates of market perceptions difficult." Id., p. 20. With more caution than confidence, they conclude that "[r]esults suggest that market estimates of the liabilities are imprecise ... Additionally, there is some evidence indicating that the market does not expect the health benefit obligation to be paid in full. This result is consistent with market expectations that the firms or the federal government will take actions to reduce future benefit payouts" (Mittelstaedt and Warshawsky Study, abstract). Thus they rationalize why they did not find the results they expected. Their study does not disprove NERA's assumptions.

---

<sup>50</sup> In one of the articles cited by Mittelstaedt and Warshawsky, it was reported: "Although many corporate executives concede that the new rule would slash reported earnings and reduce book values substantially, the FASB proposal so far has caused little stir on Wall Street.... Shrugs Lee Seidler, an accounting specialist with Bear Stearns, 'It will be a big yawn.'" D. Henriques, "Double Whammy - FASB Readies A Blow To Corporate Earnings and Balance Sheets," Barrons, April 17, 1989, p. 8.

The Mittelstaedt and Warshawsky Study, then, hardly proves MCI's point. The study has other obvious flaws. First, as MCI admits (MCI, p. 14), FASB first raised the issue of employer liability for OPEB in 1982, and issued an interim standard of disclosure in 1984. Thus, investors have been aware of this employer liability since 1982, and have had the capability to estimate its implications since 1984. If there had been any stock price reaction to the existence of OPEB liability, it would have occurred before the period (1986 to 1988) examined by Mittelstaedt and Warshawsky. And the Commission used average share prices from yet another period to determine the carriers' cost of capital -- January 1990 through July 1990. Second, for numerous variables in their equations, the authors substituted book values where market values were called for. They did so knowingly due to a lack of market data for the variables, but in so doing they mixed apples and oranges. Market and book values rarely equate. Finally, they made no attempt to identify market variables other than SFAS 106 to test their hypothesis. The stock price movements that the authors did observe could just as easily, or more likely, have been due to interest rate changes, fears of inflation or recession, government deficits or any number of other economic factors in the capital markets.

MCI also suggests that investors assumed carriers would not be granted cost recovery of OPEB expenses, and therefore discounted the carriers' stock prices. MCI, pp. 16-17. This suggestion is unrealistic. Postretirement benefits are reasonable and prudent operating expenses and utilities are and

always have been entitled to recover such expenses.<sup>51</sup> In fact, during the price cap debate, it was generally expected by many parties that costs relating to changes in GAAP would be treated exogenously and that a change to an accrual accounting for retiree non-pension benefits would be required under GAAP in the near future. Therefore, corresponding costs associated with a change to the accrual method would be treated as exogenous. This expectation was noted by the Commission in the record.<sup>52</sup> There is nothing on the record to indicate that this Commission would take a contrary view. Therefore, it would be more reasonable to conclude that investors expected these costs would be recovered.

MCI is correct in noting that "RBOC stocks are among the most widely held stocks in the country and consequently the earnings of these companies are scrutinized and researched by the major brokerage houses, as well as many of the mutual funds and trustees of large equity holders such as pension funds." MCI, p. 14. But what their investors scrutinize are liquidity and cash returns. MCI itself says that a "firm's share price reflects the present value of the current and future cash flows [i.e., dividends] expected by the holders of the firm's stock." MCI, p. 13. But MCI carefully avoids discussing what effect

---

<sup>51</sup> See above, p. 19. See also Exhibit 1, p. 17 (quoting California Public Utilities Commission Department of Ratepayer Advocates).

<sup>52</sup> Second Further Notice, 4 FCC Rcd 2873 (para. 654).

SFAS 106 would have on current or potential dividends. While the accrual accounting required by SFAS 106 properly recognizes the economic costs of OPEB and thus justifies an exogenous cost adjustment to properly match revenue and costs, there is no evidence to suggest that it has any effect on a firm's dividend policy or plans. MCI never demonstrates that SFAS 106 had any effect on the cash flows expected by stock market investors. Indeed, it implies the opposite. See MCI, p. 24.<sup>53</sup> Thus, it never proves that SFAS 106 affected either stock prices or the results of the Commission's DCF analysis.

The DCF is a financial model. While accounting works toward matching expenses with revenues to achieve temporal parity in exposition of cost and earnings, finance focuses on cash flow generation, the ability of a firm to meet its cash obligations (e.g., debt servicing) and to produce cash returns (dividends) to its investors. Thus, the DCF model focuses on cash flow to investors through current dividends and expected growth in dividends. The accounting-based profitability of a firm is only one measure of its ability to continue paying and increasing

---

<sup>53</sup> "Because SFAS-106 is merely an accounting change, the basic integrity of the LEC business will remain unchanged. Simply put, SFAS-106 will recognize a liability, but there will be an offsetting increase in assets through the funding of the OPEBs. While earnings on paper would erode by some small amount, the actual financial viability of the LECs will remain strong." This directly contradicts MCI's argument that SFAS-106 must have depressed stock prices.

dividends. If a firm's current dividend remains unchanged and investor-expected growth in dividends is unchanged, investors remain indifferent.

MCI attaches an affidavit by Professor Allan Drazen that discusses the DCF model, the effect of SFAS 106 on future earnings, and his assumption that that effect has depressed stock prices and therefore increased the dividend yield component (dividend/price) of the DCF-calculated cost of equity. Drazen concludes that by relying on DCF-based calculations to determine the cost of equity component of the unitary rate of return the Commission inflated the prescribed rate of return. He opines that the inflated rate of return compensates the carriers' investors for SFAS 106 costs. MCI, App. A.

Drazen's affidavit is premised on the assumption that the anticipated adoption of SFAS 106 depressed expectations of earnings and therefore stock prices. MCI, App. A, p. 2. "To the extent that the market anticipates a possible future change in regulations that is not reflected in current earnings or cash flows, the stock price of a company whose earnings are expected to be strongly affected will fall relative to those companies whose costs will be less affected." Id., p. 3; see also p. 15.

The first problem with this assumption is that the only support for it is the Mittelstaedt and Warshawsky Study. As shown above, Mittelstaedt and Warshawsky were not able to prove a statistically significant correlation between SFAS 106 and stock prices, and frankly admitted that the SFAS 106 effect they did posit was weak and could not be quantified with confidence.

The second problem is that the effect of depressed earnings expectations and stock prices on the DCF model would be to cancel each other out. MCI notes that the FCC used average share prices for January 1990 through July 1990 to populate the DCF model's price component and used Institutional Brokers Estimate Service (IBES) data to determine the growth component. Drazen states that "a future regulation such as SFAS 106, which is anticipated to induce a discrete downward adjustment in accounting profits when first adopted but whose exact initial impact is uncertain, should have a clear effect on reducing the stock price but a far less clear effect on estimates of G [long term growth in dividends]." MCI, App. A, p. 3. After having acknowledged the effect of expected future earnings on stock prices, and assuming that SFAS 106 did in fact reduce stock prices, Drazen thus dismisses the supposed effect of SFAS 106 on future earnings and assumes its effect on the consensus growth rate estimates compiled by IBES can be disregarded. This makes no sense. In fact, if Drazen's premise has any merit and future earnings expectations associated with SFAS 106 have depressed stock prices, then it also follows that investment analysts have reduced their forecasts of earnings growth rates and this reduction is reflected in the IBES data. Any reduction in the IBES consensus long-term expected growth rate the Commission used to represcribe the rate of return would depress the G component in the DCF model which in turn would have reduced the resulting cost of equity and the prescribed rate of return.

Ad Hoc and ICA make a similar contention. They claim that "FAS 106 effects already are discounted to some degree in the existing nationwide average rate of return prescribed for all carriers." ETI Study, p. 2 (emphasis in original). They cite the availability of "a large data base of health care prices, costs, employee contributions and co-payments, eligibility requirements, deductibles and other insurance requirements" to "actuaries, securities analysts, insurance and benefits consultants and any other analyst who may have cared to compute long-term health care costs for any segment of the population." Id., p. 11. They note that rate of return prescription "explicitly relied on ... IBES data on dividends, earnings and stock prices as part of the discounted cash flow analysis used to establish the prescribed return on equity. IBES data were determined by the FCC to be a reasonable expectation of investor expectations." Id.

Ad Hoc and ICA have made the same mistake that MCI did. If, as they assume, the impending liability for SFAS 106 costs would have depressed stock prices, the reason should have been reduced dividend and earnings expectations. If stock prices and dividends and earnings expectations were both reduced, it is likely that the cost of equity would be largely unaffected. There is no evidence that stock prices or earnings expectations were affected by news of SFAS 106. Even if stock prices or earnings expectations were affected by SFAS 106, there is no reason to believe that SFAS 106 affected the Commission's prescription of the carriers' rate of return.

II. THE PACIFIC COMPANIES' DEVELOPMENT OF THE SFAS 106  
ACCRUAL IS REASONABLE.

SFAS 106 instructs carriers how to determine annual net accrued OPEB expense. AT&T, MCI, Ad Hoc, and ICA, however, complain that because the calculation of this accrual is to some degree within carriers' control, limits should be placed on the parameters used to develop SFAS 106 accruals. They contend that the actuarial assumptions underlying the carriers' accruals vary widely and should either be prescribed by the Commission or measured against benchmarks. Finally, they complain that the results are highly speculative. See AT&T, pp. 16-29; MCI, pp. 27-29; Ad Hoc, p. 13; ETI Report, p. 8, Table A.

These contentions imply that the guidelines provided in SFAS 106 are insufficient or inappropriate for determining how a carrier determines OPEB accruals. The guidelines in SFAS 106 were debated for years before being adopted. Their stated purpose is to standardize how companies determine the accruals, and compliance is mandatory for publicly held companies. That there may be a range of reasonable assumptions does not make each carrier's choice invalid. Under SFAS 106, the burden is on each company to choose the set of assumptions that is most appropriate to it, and be prepared to justify every assumption under audit. Contrary to what some parties imply, this is not an obligation that can be taken lightly. The assumptions cannot be manipulated without exposing the carrier to a substantial possibility of liability to investors and regulators.

One limit on the actuarial assumptions under SFAS 106 is that they should be (and for the Pacific Companies they are) identical or very similar to those used under SFAS 87, which determines pension accruals. These include all of the demographic assumptions used to calculate the SFAS 106 accrual, such as the rates of retirement, disability, mortality, and turnover. They also include the discount rate. The contention that there is a great deal of room for imagination or manipulation in actuarial assumptions is unsupportable for this reason alone. In fact, when it allowed carriers to adopt SFAS 87 for both regulatory and financial accounting purposes, the Commission considered and rejected similar contentions that "severing the link between actual funding in a given year and independently calculating annual pension expenses that are recognized for ratemaking purposes eliminates any incentive to fund pension plans properly."<sup>54</sup> As the Commission then noted of SFAS 87, there were other regulatory forces, such as ERISA and contractual obligations with employees, that mandated proper funding levels.<sup>55</sup>

---

<sup>54</sup> Use of Generally Accepted Accounting Principles in Part 32 of the Commission's Rules, 2 FCC Rcd 6675, 6677 (para. 14) (1987). ("GAAP in Part 32").

<sup>55</sup> Id.

The parties opposing OPEB cost recovery also propose to mix and match discount rates, rates of return on plan assets, and health care trend rates from various carriers. The fact is that a set of actuarial assumptions for each carrier's SFAS 106 accrual must be arrived at not only selecting the best estimator for each assumption, but also making sure that these assumptions are consistent with each other. For instance, the discount rate and the health care trend rate must both use the same assumption of general inflation as an underlying component; the former adds to this the real rate of return, while the latter adds to this health care-specific inflation. Therefore, the two rates are interdependent. Furthermore, the health care trend rate used in the actuarial model must reflect a GNP which is ultimately composed of a reasonable percentage of health care products and services in the long term. If it is too high, the health care trend rate could result in the model's entire GNP being comprised of health care products and services. If too low, it could result in the GNP being comprised of a smaller health care component than it is reasonable to expect in the near future.

The assumption that AT&T proposes as appropriate for the health care trend rate begins at 10% and decreases by .4% each year to an ultimate rate of 4%. The validity of its assumptions cannot be established without knowing what percentage of GNP as health care it ultimately produces in conjunction with the assumptions for general inflation (and thus, what discount rate is appropriate). AT&T chose it based on a national index report

(AT&T, App. H), which assumes a particular type of plan and ignores certain details such as adverse selection.<sup>56</sup>

The best assumption for the health care trend rate is one that reflects a company's actual experience in the near term and results in the most reasonable composition of GNP in the long term. Pacific's current health care trend rate is approximately 14%. Similarly, SFAS 106 mandates that the discount rate is to be based on a firm's definition of high quality fixed investments. Each carrier's calculation of rate of return on plan assets may also differ, as SFAS 106 prescribes the use of actual investment experience on plan assets and future expected contributions.

MCI alleges that using an outdated turnover rate would greatly overstate the SFAS accrual. MCI, p. 28. This is generally not the case for companies like Pacific due to the significant amount of the OPEB liability related to retirees and employees near retirement. In this instance, turnover rates are not even used to calculate the accrual. Specifically, an assumed turnover rate of 1% at age 30 does not affect calculations for a participant currently older than 30. Ad Hoc (p. 14) suggests

---

<sup>56</sup> Adverse selection refers to the use of health care benefits by individuals who enter the health care delivery system with pre-existing medical conditions. Such individuals skew average per capita costs upward because they do not reflect the norm.

that OPEB accruals can be inflated by including employees who will never retire with benefits. The actuarial calculations take into account the probabilities for each future year that each employee will or will not receive benefits.

AT&T makes the argument that per employee OPEB costs vary tremendously from one carrier to another. AT&T, pp. 21-22. As shown above, this should come as no surprise. In the chart in Appendix E of its filing summarizing the results, however, it is not clear whether AT&T has used a reasonable method to come to this conclusion or whether its results are meaningful. Dividing 1993 projected OPEB costs by 1991 plan participant counts from each company's Form M is overly simplistic. It overstates the volatility of OPEB expense per employee because the year of the headcounts does not match the year of the projected OPEB expense. AT&T ignores the fact that prefunding by individual carriers also significantly affects the volatility of this calculation. As the Commission is aware,<sup>57</sup> some carriers have prefunded OPEB expenses in VEBA trusts, and some have not. No meaningful comparisons can be made among the carriers due to unique circumstances concerning prefunding, benefit levels necessary to retain quality employees in particular geographic areas and other demographic differences.

---

<sup>57</sup> See above, p. 19.

AT&T, MCI, and Ad Hoc contend that the carriers' medical expense plan, Medicare Part B premium reimbursement, and dental care plan costs should be capped at 1/1/93 levels for all employees retiring after that date. This is unrealistic. The carriers are not as free to reduce or eliminate OPEB as these parties suggest. Even the Mittelstaedt and Warshawsky Study that MCI cites states the fact:

Although some employers may view retiree health benefits as a mere gratuity, subject to their unilateral decision to amend or cancel the plan benefits, legal and practical considerations may make the benefits a fairly fixed obligation. As a legal matter, the ability of carriers to cancel or amend benefits is highly uncertain, owing to different precedents established in different circuits of the federal courts in interpreting the language of contracts and the intentions of relevant parties. More importantly, as a practical matter, concerns about ethics, labor relations (particularly in a unionized environment), and public relations impose constraints on the ability of employers to act unilaterally on this issue.<sup>58</sup>

If benefits were capped at the 1/1/93 level, in a fairly short time medical inflation would increase the level of retirees' contribution to medical costs so much that it would be impossible for carriers to maintain such a cap without causing undue hardship to the retirees. Therefore, it is very unlikely such a cap could be permanently maintained. At the very least, any

---

<sup>58</sup> Mittelstaedt and Warshawsky Study, p. 3.

reduction in OPEB expenses would likely be at the cost of compensatory increases in wages and other benefits. Paragraph 25 of SFAS 106 also addresses this issue:

An employer's past practice of maintaining a consistent level of cost sharing with its retirees or consistently increasing or reducing its share of the cost of providing the covered benefits shall not constitute provisions of the substantive plan if accompanied by identifiable offsetting changes in other benefits or compensation or if the employer incurred significant costs, such as work stoppages, to effect that cost-sharing policy. Similarly, an employer's communication of its intent to institute cost-sharing provisions that differ from the extant written plan or the past cost-sharing practice shall not constitute provisions of the substantive plan (a) if the plan participants would be unwilling to accept the change without adverse consequences to the employer's operations or (b) if other modifications of the plan, such as the level of benefit coverage, or providing offsetting changes in other benefits, such as pension benefits, would be required to gain plan participants' acceptance of the change to the cost-sharing arrangement.

AT&T engaged Milliman and Robertson, Inc. to perform a sensitivity analysis related to SFAS 106 accrual calculations. Their findings indicated a great deal of sensitivity to changes in actuarial assumptions associated with small changes in economic assumptions, such as a 1% increase in the discount rate. Therefore, they claim that exogenous treatment for SFAS 106 costs is contrary to the Commission's policy. AT&T, p. 23.

This is not a reason to deny recovery of SFAS 106 costs. Accruals of employee benefit costs, such as pensions and OPEB, will always be sensitive to changes in assumptions because